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ZNR UUUUU ZZH
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FM AMEMBASSY MEXICO
TO RUEHC/SECSTATE WASHDC PRIORITY 0439
INFO RUEHXC/ALL US CONSULATES IN MEXICO COLLECTIVE
RHEHNSC/NSC WASHDC
RHMFIUU/CDR USSOUTHCOM MIAMI FL
RHMFIUU/CDR USNORTHCOM
RUEHC/DEPT OF LABOR WASHDC
RUCPDOG/DEPT OF COMMERCE WASHDC
RHMFIUU/DEPT OF ENERGY WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 03 MEXICO 000357

SIPDIS

SENSITIVE
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STATE FOR A/S SHANNON
STATE FOR WHA/MEX, WHA/EPSC, EB/IFD/OMA, AND DRL/AWH
STATE FOR EB/ESC MCMANUS AND IZZO
USDOC FOR 4320/ITA/MAC/WH/ONAFITA/GERI WORD
USDOC FOR ITS/TD/ENERGY DIVISION
TREASURY FOR IA (ALICE FAIBISHENKO, ANNA JEWEL)
TREASURY FOR IA (ALICE FAIBISHENKO)
DOE FOR INTL AFFAIRS KDEUTSCH, ALOCKWOOD, AND GWARD
NSC FOR RICHARD MILES, DAN FISK
EXIM FOR MICHELE WILKINS
STATE PASS TO USTR (EISSENSTAT/MELLE)
STATE PASS TO FEDERAL RESERVE (ANDREA RAFFO)

E.O. 12958: N/A

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SUBJECT: MEXICAN OFFICIALS DISCUSS INFLATION, GROWTH, AND
REFORM EFFORTS

REF: MEXICO 240

Summary and Introduction

¶1. (U) Key cabinet members and economists discussed economic challenges for the Mexican economy at a seminar hosted by the Autonomous Technological Institute of Mexico (ITAM) last month. Bank of Mexico Governor Ortiz said that the impact of the 2007 fiscal reform on inflation may be smaller than previously expected. To the surprise of many in the audience, he said that the new gasoline tax hike will not adversely affect inflation since the monthly gasoline price increase will actually be smaller after the tax,s implementation. Both Ortiz and Finance Secretary Carstens said that Mexico is better positioned to weather a U.S. recession than it was in 2001 thanks to solid macroeconomic fundamentals, strong domestic demand, and increased government spending. The head of President Calderon's economic cabinet commented on how the government has strengthened public finances and reduced the economy's "operational costs." Labor Secretary Lozano spoke about the need to make the labor market more flexible and competitive without touching Article 123 of the constitution. The head of the Automobile Distributors Association complained about businesses overregulation, the slow judicial process, and the government's lack of support for small businesses. End Summary.

BOM Governor Discusses Inflation and Growth Outlook

¶2. (U) Bank of Mexico (BOM) Governor Guillermo Ortiz said that the impact of fiscal reform on inflation may be smaller than previously expected. He remarked that it was difficult

to measure how the new Single Rate Corporate Tax (IETU) would affect inflation, adding that it may be less than what the BOM had estimated at the end of last year. To the surprise of many in the audience, Ortiz said that the new gasoline tax hike will not/not adversely affect inflation since the monthly gasoline price increase will fall from around 3 centavos per month before the tax's implementation to around 2 centavos per month. (Note: the government adjusts the price of gasoline each month according to inflation. Post assumes that Ortiz's statement means that the government will halt these adjustments, and only increase gasoline prices as specified in the gasoline tax hike. End Note.) Ortiz said that the main risks to inflation in the short term include: potential contamination from supply shocks into other prices in the economy; additional hikes in international food prices; a greater slowdown in the U.S.; and an increase in volatility in international financial markets. He said that so far there are no signs that high food prices have contaminated salaries or long-term inflation expectations.

13. (U) Ortiz said that while the Mexican and U.S. economies are still tied together -- especially through the manufacturing sector -- Mexico is better prepared to handle a U.S. recession than it was in 2001. He highlighted Mexico's solid macroeconomic fundamentals and the dynamism of the domestic economy. He remarked that the banking sector is stronger and extends more credit to the private sector than it did in 2001. The expected public-private investment in infrastructure of 5% of GDP will also help reduce the effect of a U.S. recession. Ortiz added, however, that Mexico's growth prospects would depend in part on the "size" of the U.S. recession. As in other forums, Ortiz called for the approval of labor, education, and telecommunications reforms,

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the elimination of corruption, and improved rule of law.

Carstens Expresses Confidence in Mexican Economy

14. (U) Finance Secretary Agustin Carstens also said that Mexico is better positioned to weather a U.S. recession than it was in 2001 thanks to solid macroeconomic fundamentals, strong domestic demand, investment in infrastructure, and expected growth in the housing sector. The 2007 fiscal reform and high oil prices will allow the government to implement countercyclical fiscal policy. He remarked that programmable expenditures are set to rise 10.5% this year and that investment in infrastructure will reach a record high. Carstens also noted that the government has been able to consolidate the banking sector, which is now lending more to the private sector.

Government Actions To Strengthen Economy

15. (U) Felipe Duarte Olvera, head of President Calderon's economic cabinet, said that the government strengthened public finances via the passage of the fiscal and pension reforms, its commitment to maintain fiscal discipline, and its efforts to improve the country's debt profile. The pension reform will allow savings equivalent to 24% of GDP over time, and the fiscal reform allows the government to earmark more resources for social development and infrastructure and to reduce the country's reliance on oil revenues.

16. (U) The government also has taken steps to reduce the economy's "operational costs," such as reducing the time to open a new business, lowering industrial electricity rates during peak hours, strengthening development banks, and fostering more competition in LP gas distribution. The government also created Promexico, an agency that will promote Mexico as a safe and attractive destination for

foreign investment.

Labor Secretary Calls for Reform

¶7. (U) Labor Secretary Javier Lozano spoke about the need to make the labor market more flexible and competitive without touching Article 123 of the constitution -- the foundation for all federal labor laws. He proposed including productivity requirements in collective contracts and modifying the "contratos-ley" (an industry-wide collective bargaining agreement) in the textile and rubber sectors, for example. The government recently negotiated a modification to the sugar industry's contract to make the sector more competitive. Another challenge for the Secretariat will be developing training programs and investing in human capital.

Auto Sector's View of the Economy

¶8. (U) Jose Gomez, the head of the Automobile Distributors Association (AMDA), complained about overregulation of businesses and the slow judicial process. He said that it takes an average of 421 days to conclude the judicial process in Mexico. Gomez remarked that the government's financial support to small- and medium-sized enterprises (SMEs) is insufficient. He said that only 0.11% of the budget was

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channeled to SMEs from 2001 through 2006 even though SMEs account for 72% of total employment. Gomez called for the approval of structural reforms and a policy to reduce the importation of used vehicles, which has affected his sector.

Comment

¶9. (SBU) Carstens' and Ortiz's views aside, Mexico's economy is closely linked to that of the U.S. and will undoubtedly suffer if the U.S. slips into recession. The BOM and Finance Secretariat have both revised downward their GDP growth

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forecasts for this year, due largely to slower U.S. growth. If the situation in the U.S. worsens, we can expect these forecasts to fall even further.

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